

Guide for Employers Considering Health Flexible Spending Accounts

This guide is for informational and educational purposes only. It does not constitute legal advice or a comprehensive guide to issues to be considered in establishing a Health Flexible Spending Account or Health Reimbursement Arrangement. If your organization chooses to establish such a program, its tax and/or legal adviser should be consulted in the process.

There are two benefit programs, in addition to the Benefits Plan programs administered by the Board of Pensions, that employers may establish and offer to employees to help ease the payment of their unreimbursed medical costs. Both programs provide for the payment of such costs with pre-tax dollars.

A Health Flexible Spending Account (“Health FSA”) is a program through which an employee makes before-tax contributions to an account and is then reimbursed from the account for certain eligible medical expenses.

A Health Reimbursement Arrangement (“HRA”) is a program funded solely by the employer that provides reimbursement for certain medical expenses up to an annual limit.

Details about the two programs are described in this document which generally explains their legal requirements.

The Board of Pensions does not offer a Health FSA or an HRA. However, sample information is available from the Board of Pensions if you decide to adopt a Health FSA plan for your organization. The Board of Pensions has not developed more specific information on HRAs pending further guidance on these programs from the IRS.

A Health Flexible Spending Account

Background. A Health FSA is a program under Section 125 of the Internal Revenue Code that allows an employee to set aside a part of salary on a pre-tax basis and use the money to be reimbursed for eligible healthcare expenses the employee incurs for himself or herself or his or her eligible dependents. It is operated through a “cafeteria plan,” enabling participants to pay the expenses on a pre-tax basis.¹ To qualify for the advantage on a pre-tax reimbursement, the Health FSA must follow certain rules established by the Internal Revenue Service (IRS).

These rules:

- limit changes in salary reduction elections mid-year;
- require that all amounts contributed to the Healthcare FSA be used during the plan year (or grace period) or be forfeited; and
- require that the program not be discriminatory.

Establishing a Health FSA. An employing organization must adopt a plan document setting forth the terms and conditions of the Health FSA. The document will establish rules relating to eligibility, approved reimbursable expenses, salary reduction agreements, and when elections may be changed.

Eligible Participants. An employing organization sets the eligibility requirements for employees who can participate in the Health FSA. Only employees may participate in a Health FSA. A self-employed individual is not considered an employee for Health FSA purposes. A minister employed by a congregation is considered self-employed for Social Security purposes (pays SECA instead of FICA) but an employee for federal income tax purposes. Employed ministers are eligible to participate in a Health FSA.

¹ The information provided in this document only covers the cafeteria plan requirements for Health FSAs. Employers may also establish Flexible Spending Account plans for dependent care expenses. If an employer offers a cafeteria plan established under Section 125 of the Internal Revenue Code, it may also permit pre-tax contributions toward disability, life insurance (other than dependent life), and medical plan premiums. Consult with your own legal or tax advisors if you want to offer additional cafeteria plan options.

B How the Health FSA Works

Voluntary Salary Reduction Election. A Health FSA enables an employee to be reimbursed with his or her own pre-tax dollars for eligible expenses not covered by the Medical Plan. An employee participating in a Health FSA voluntarily elects to reduce his or her salary by a specified amount each year. **The amount selected is reduced from the employee’s paycheck, generally in an equal amount per paycheck, but the entire amount of the elected annual contribution must be available immediately to pay reimbursable expenses.** This may require current payment from employer funds until subsequent recovery from future employee contributions. Most employers establish a maximum contribution amount for employee salary reduction contributions. The total reimbursable expenses for the coverage period cannot exceed total pre-tax contribution election through the Health FSA for the year.

Mid-Year Election Changes. Under IRS rules, an employee's salary reduction contribution election must be set for the entire plan year. An employee may not change the amount of his or her salary reduction election during a plan year unless the employee has a "qualifying change in status event" or other recognized reason for a mid-year election change. Any election change must be consistent with the qualifying event. A qualifying change in status event includes a change in:

1. Legal marital status, including marriage, divorce, the death of a spouse, legal separation, or annulment
2. The number of the employee's dependents, including birth, adoption, placement for adoption, or the death of a dependent
3. The employee's, spouse's, or dependent's employment status that is a termination or commencement of employment, a strike or lockout, a commencement of or a return from an unpaid leave of absence, or a change in worksite
4. The employee's, spouse's, or dependent's employment status that causes the individual to become or cease to be eligible for the plan, which may include a change in work schedule or a change between salaried and hourly employment
5. The employee's dependent's eligibility for coverage under the plan because of the attainment of a particular age or other similar event
6. The employee's, spouse's, or dependent's residence

In addition to qualifying change in status events, an employee may also change his or her salary reduction election mid-year.

1. If the employee or employee's dependent is or becomes entitled to Medicare or Medicaid coverage, the employee may change his or her election to cancel or reduce coverage.
2. If the employee or the employee's dependent loses eligibility for coverage under Medicare or Medicaid, the employee may elect to commence or increase coverage.
3. If a child coverage order requires coverage of an employee's child, the employee may change his or her election.
4. If a child coverage order requires a spouse or former spouse to provide coverage, the employee may change his or her election.

An employing organization may choose to incorporate some, all, or none of the mid-year election change options into its Health FSA.

Use-it-or-Lose-it Rule. Any money that remains in an employee's Health FSA account after the end of the claims period is forfeited and becomes property of the plan. The employer can elect whether the claims period ends at the end of the calendar year the plan year (if different from the calendar year) or whether the claims period extends a two and a half month "grace period" following the end of the calendar year or plan year. (Claims incurred during the applicable claims period may be submitted for reimbursement after the end of the claims period up to a specified date determined by the employer.) It is important for a Health FSA participant to accurately budget medical expense amounts in order to avoid losing money set aside in the account. **Outside of the two and a half month grace period, Health FSA salary reduction contributions may not be carried over from year to year.**

If any money reverts to the plan after the end of the claims period, the plan should generally use the money to offset administrative expenses. It may instead make a charitable donation or allocate the funds uniformly to participant accounts for the following year as long as that allocation is not in relationship to amounts forfeited.

Qualified Benefits under the Health FSA. A Health FSA participant may be reimbursed only for qualified medical expenses up to the amount the participant elected to contribute to the Health FSA. Qualified medical expenses are expenses for healthcare services for the participant and his or her spouse and dependents that are not paid under the employing organization's healthcare benefit coverage or otherwise reimbursed or claimed as a deduction on his or her tax return. Qualified medical expenses generally include any healthcare expense that the participant could deduct on his or her federal income tax return if the individual qualified for the itemized deduction of medical expenses. A participant may not be reimbursed for any medical or other insurance premiums under a Health FSA. If your employees are contributing to their medical and/or dental coverage, you need to establish a separate cafeteria plan to provide for pre-tax payments of those sums. (Employee contributions are permitted for the Affiliated Benefits Program medical coverage and optional dental coverage. Medical coverage under the Traditional Program is noncontributory.)

The following list includes some of the most common eligible healthcare expenses:

- Any amount that is paid primarily for the diagnosis, cure, mitigation, treatment, or prevention of disease, including copayments or other cost sharing for routine medical and dental checkups.
- Any amount paid for the purpose of affecting any structure of the body. This includes not only surgery, but also the purchase of equipment that is used to help the body function properly, including prescription eyeglasses and contact lenses.
- The purchase of any prescription drug or insulin; the purchase of over-the-counter drugs may be reimbursed **only if they are prescribed**.
- Transportation, which is primarily for, and essential (not merely convenient) to, receiving medical care.
- Payment of the portion of any healthcare expenses otherwise described above that is not reimbursed under the employing organization's medical plan because of deductibles or copayment requirements, usual, reasonable, and customary fee limitations, or other limitations on the amount or nature of benefits covered by the employing organization's medical plan.

Administering the Health FSA. The employing organization can administer the Health FSA internally or may appoint a third-party administrator. Ultimately, the employing organization will be considered "plan administrator" for purposes of the Health FSA and will have a fiduciary duty to operate the plan solely in the interest of plan participants and their beneficiaries.

Filing Claims under the Health FSA. Claims for qualified expenses under the Health FSA should be submitted as soon as possible after they are incurred, but in no circumstance later than a set number of days after the end of the claims period. The claim must clearly identify the dollar amount of the expenses, the date, the provider, and type of service claim. Photocopies of bills, receipts, or cancelled checks should be used as proof of incurred expenses. The Health FSA participant must certify that the expense for which reimbursement is sought has not been compensated by insurance or otherwise and has been incurred during the plan's claims period. The employer will have to implement a claim reimbursement procedure.

The Health FSA may not reimburse a medical care expense that is attributable to a federal income tax deduction for any year. Qualified expenses must be incurred after the execution of the salary reduction agreement, on or after the beginning of the plan year, and while the individual is participating in the Health FSA.

Impact on Employing Organization. The employing organization must cover the costs of administering the plan. Costs include plan documentation, preparation of forms, withholding salary reduction contributions, processing Health FSA reimbursements (including reimbursements for which salary reduction amounts have not yet been contributed), and legal compliance updates, as required.

As mentioned previously, an employee participating in a Health FSA is entitled to be reimbursed for the full amount of his or her salary reduction from election at the beginning of the plan year (i.e., before he or she has made the full amount of contributions to the Health FSA for the year). That means the employing organization must make available to the employee the full amount of his or her elected benefit whenever reimbursable expenses occur. For example, if an employee's voluntary salary reduction Health FSA election is \$1,200 per year (\$100 per month), the employee can receive reimbursement for a qualified expense of up to \$1,200 in the first month of FSA participation. Since only \$100 will have been paid into the account by the end of the first month, the employing organization must come up with the additional \$1,100 for reimbursement. The employing organization will continue reducing the participant's salary for the remainder of the plan year.

The employing organization will encounter some benefit savings from the Health FSA. When salaries are reduced, the cost to the employing organization for benefits related to salary may also decrease. The employing organization will have to pay less to Social Security for lay employees.

Under current Health FSA rules, the funds remaining in employees' FSA accounts at the end of the grace period are forfeited to the benefit of the plan. The plan may use such funds to cover the cost of the plan administration or to make benefit contributions for employees in future years. Such contributions must be allocated equitably among all participants; an employer may not allocate in proportion to the amount that an individual employee "lost" in the preceding year's account.

Employee Impact. Under a Health FSA, an employee can reduce his or her taxable income and use the reduction to pay for expenses that otherwise would have been paid with after-tax dollars. Employee tax savings include federal income tax and state and local income tax in most, but not all, states. An employee will not pay Social Security tax on amounts excluded from income. Ministers will not pay SECA taxes on the amounts set aside for a Health FSA.

Social Security benefits are based on salary earned throughout an employee's career. If an employee contributes to a Health FSA, his or her taxable salary may be less than it otherwise would have been and Social Security benefits may be lower. The same could be true for worker's compensation and unemployment benefits.

C Health Reimbursement Arrangement

Background. A Health Reimbursement Arrangement (“HRA”) is a program established under Section 105 of the Internal Revenue Code through which an employer can offer to reimburse employees for certain medical expenses on a nontaxable basis. The employing organization pays all HRA expenses; no employee salary reduction contribution is permitted. Reimbursements under a HRA are subject to fewer restrictions than Health FSAs. The unused portion of the employing organization’s contribution can be carried over and accumulated for future reimbursements from year to year if the employing organization chooses to offer such an arrangement. Medical expenses reimbursed through an HRA for an employee and his or her dependents are not subject to federal income, Social Security, or SECA taxes.

Establishing an HRA. An employing organization must adopt a written plan setting forth the terms and conditions of the HRA. HRAs are subject to certain Internal Revenue Code nondiscrimination rules.

Eligible Participants. An employing organization sets the eligibility requirements for employees who may participate in the HRA. Reimbursements may be provided to current and former employees (including retired employees), their spouses and dependents, and the spouses and dependents of deceased employees. “Employee” does not include a self-employed individual. A minister employed by a congregation is considered self-employed for Social Security purposes but an employee for federal income tax purposes. Employed ministers are eligible to participate in HRAs.

How the HRA Works. The employing organization determines a set dollar amount that it will reimburse annually or contribute to an account for reimbursement of an employee’s eligible medical expenses. The employee may submit requests for reimbursement of expenses incurred for medical care up to the annual amount (or the accumulated amount if the employing organization’s plan provided for year-to-year accumulations). The types of expenses eligible for reimbursement from an HRA are the same as those under the Health FSA. However, unlike the Health FSA, amounts paid for dues or premiums for accident or healthcare coverage for current employees, retirees, continuation beneficiaries, and their dependents may also be reimbursed from the HRA.

Administering the HRA. The employing organization may administer the HRA internally or may appoint a third-party administrator. Ultimately, the employing organization will be considered “plan administrator” for purposes of the HRA and will have a fiduciary duty to operate the plan solely in the interest of plan participants and their beneficiaries.

Filing Claims under the HRA. An HRA participant must provide written substantiation of any requested medical expense reimbursement under the HRA. The HRA may not reimburse a medical care expense that is attributable to a federal income tax deduction for any year. Qualified expenses must be incurred while the HRA is in existence and while the individual is participating in the HRA. The employing organization will have to implement a claim reimbursement procedure. The plan should establish a reasonable claims limitation period after the close of the calendar year for the filing of claims. Unlike the Health FSA, the maximum available reimbursement is limited to the accumulated HRA balance.

Impact on Employing Organization. The employing organization must cover the cost of funding the HRA. Costs include the yearly contribution and the recordkeeping involved with processing reimbursement requests and accounting for any amounts that the HRA permits an employee to carry over from year to year. Employing organizations offering HRAs will have to monitor IRS developments to ensure continued legal compliance.

Employee Impact. An employee participant in an HRA has greater control over his or her healthcare dollar than through a Health FSA. The employee can use the HRA for reimbursement for dues contributions (e.g., dependent continuation coverage), and if the participant does not use the amount in the HRA by the end of the year, it may be carried over to the next year if the plan so provides. The employing organization contribution to the HRA will be excluded from gross income to the employee.

D Offering Both a Health FSA and an HRA

If both programs are offered, the Health FSA is used first unless that plan specifically provides that the HRA is primary. The advantage to using the Health FSA first is that the HRA is not necessarily subject to the “use it or lose it” rule and may include a rollover provision.

Tax Consequences

Benefits offered under either a Health FSA or HRA will generally not be subject to federal income tax. Neither the employer nor the employee will pay Social Security (or SECA) taxes on the reimbursed sums. State and local income tax treatment varies state by state. An employing organization should consult with its tax counsel before implementing a Health FSA or HRA.

Church Plan Status

Generally a Health FSA or HRA is a welfare plan subject to the Employee Retirement Income Security Act of 1974 (ERISA). ERISA imposes specific disclosure and recordkeeping requirements on plans. However, welfare plans established by church employing organizations are church plans and are exempt from ERISA unless the plan makes an affirmative election under Section 410(d) of the Internal Revenue Code to be subject to ERISA. The Benefits Plan of the Presbyterian Church (U.S.A.) has not elected to be subject to ERISA.

E Non-Discrimination Issues

Health FSAs and HRAs are subject to complicated nondiscrimination requirements under the Internal Revenue Code. In general, the eligibility, contribution, and benefit provisions of the programs may not discriminate in favor of highly compensated employees or key employees.

Your legal or tax counsel can advise you further on this subject if you choose to offer such a program to only select employees.

F Health FSA or HRA Participation and the Federal Income Tax Deduction

An individual who itemizes deductions on his or her tax return may deduct medical expenses in excess of 7.5% of adjusted gross income.

If expenses are reimbursed through a Health FSA or HRA, the expenses may not be counted toward the income tax deduction amount.

An individual will have to determine, based on his or her tax rate and amount of medical expenses, if it is more advantageous to participate in a Health FSA or HRA or to take the deduction on his or her tax return.

G Issues to Consider when Implementing a Health FSA or HRA

An employing organization wishing to implement a Health FSA or HRA should consider the following:

- Will the arrangement benefit employees?
- Will employees want to contribute to the program?
- Can employees afford to contribute to the program?
- Does the employing organization want to contribute to the program?
- Can the employing organization afford to contribute to the program?
- Does the employing organization have the administrative capacity to administer the program?
- What mid-year election changes will the employing organization recognize under the Health FSA?
- Does the employing organization want to allow HRA contributions to be accumulated from one plan year to the next?
- Does the employing organization want to continue HRA eligibility for terminated and/or retired employees?
Surviving dependents?
- How will the employing organization keep abreast of changing laws and regulations?

H Further Information

The Board of Pensions has prepared samples of the Health FSA Plan document and the Session Resolution you will need to establish a Health FSA. Please contact Member Services at 800-773-7752 (800-PRESPLAN).